IN THE

Supreme Court of the United States

OCTOBER TERM, 1927

No. [redacted] 4

UNITED FUEL GAS COMPANY,

Appellant,

vs.

THE PUBLIC SERVICE COMMISSION OF WEST VIRGINIA, BIRK S. STATHERS, ERNEST D. LEWIS, *et al.*

SUPPLEMENTAL BRIEF OF INTERVENING APPELLEES, THE CITIES OF CHARLESTON AND HUNTINGTON, *et al.*

ROBERT S. SPILMAN,
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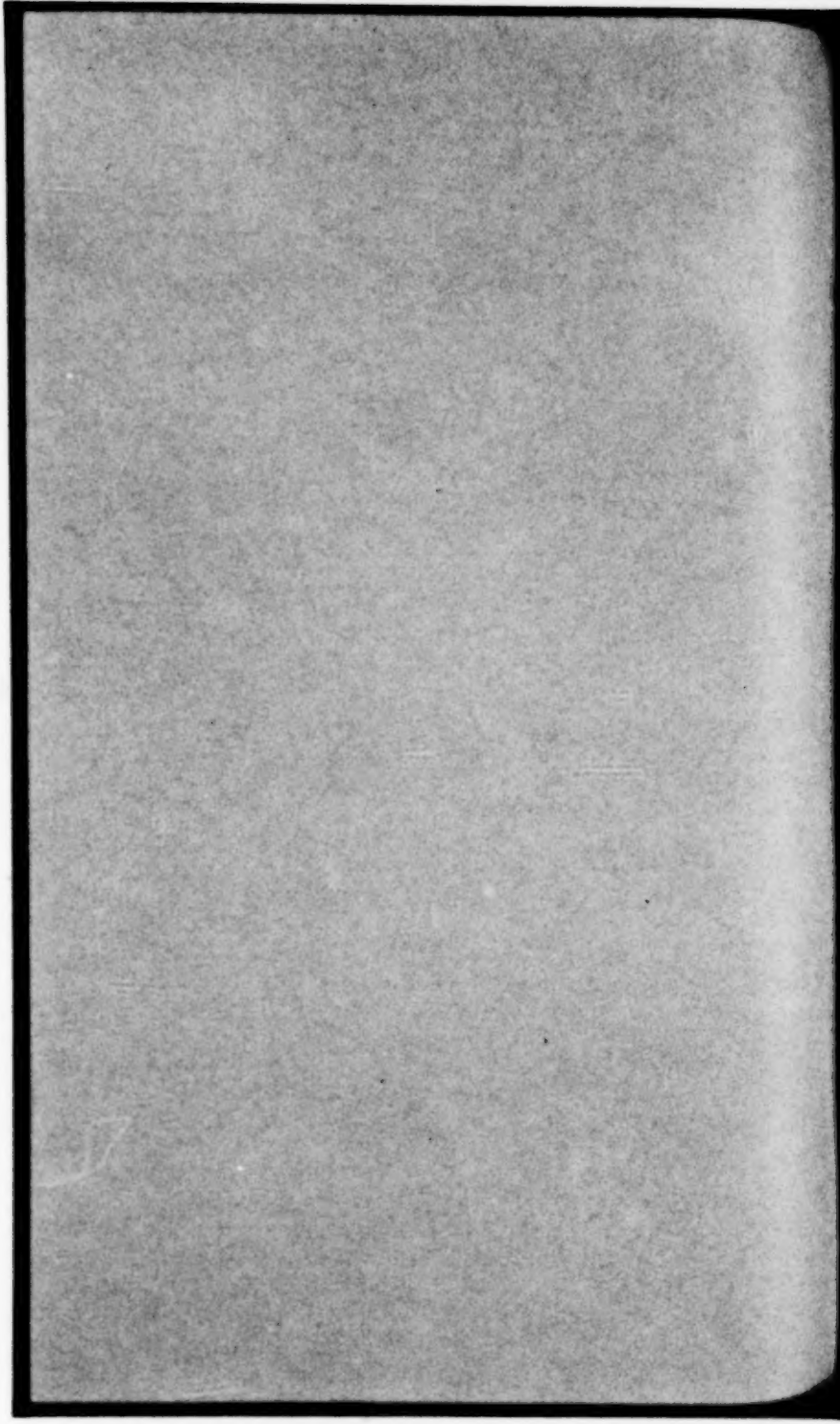
Counsel for Appellees.



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SCOPE OF THIS BRIEF

The purpose of this brief is to direct special attention to certain propositions already advanced in the briefs and in the first argument of the case, and to consider certain of the inquiries of the court upon that argument.

CAPITALIZATION OF PLAINTIFF'S EARNINGS

In the main brief protestants stated that the controlling question in this suit is not whether the fair value found by the commission is inadequate, but whether the value produced by capitalizing plaintiff's net earnings from its whole business from existing rates equals or exceeds any reasonable fair value sustained by the evidence. The effec-

tive values arrived at by capitalizing the net earnings at the percentages approved by the Commissioners and the District Court range from $53,300,000 to $74,300,000. (Brief, p. 59.) The most that plaintiff says in its reply brief relative to this statement of the issue is that it is a "reversal of the accepted method of approach to a discussion of rates." It is the method of approach which was adopted by the District Court.

Upon the first oral argument, however, a new element was introduced which bears directly on the application of the capitalization theory to this suit. Certain inquiries were made by the court as to the relation of the plaintiff's interstate to its intra-state business, the query seeming to be: Has the Commission given improper consideration to interstate business in fixing retail rates in West Virginia? The matter of interstate transportation has never been and is not now a factor in this case. Throughout the history of the case from 1916 to the decisions of the Court and Commission here complained of the company never has attempted to separate its business into interstate and intra-state business, and in no case has the Commission made the distinction. Perhaps these inquiries are due to the language of Judge Rose wherein he distinguishes what he terms "regulated" from "unregulated" business. In the first he included industrial and domestic consumers in West Virginia. In the second he included sales to wholesale consumers "for the most part" engaged in transporting the gas to other states and distributing it there. Plaintiff (Brief, p. 8) attempted the same distinction when it stated that its consumers were divided into two classes, (1) buyers at the state line, including the two parent companies and (2) domestic and industrial consumers in West Virginia.

Upon the argument of this case we called attention to the fact that it is error to speak of the delivery of gas at the state line. Neither Cedarville nor Balls Gap which

are the points of delivery of the greater part of plaintiff's gas sold to wholesale customers, is at the state line, the former being located about sixty-three miles from the Pennsylvania line, and the latter about twenty-five miles from the Kentucky-Ohio line. While there are a few general statements in the record that much of the gas purchased by some of the wholesale buyers ultimately went out of the state, the evidence submitted is much too meagre to constitute a basis for a finding that the wholesale business was inter-state in character and not to be considered in connection with the domestic revenues on the question of confiscation. We think the question of interstate commerce beside the point. It never has been deemed a factor in the case either by any tribunal or by the parties to the rate inquiries.

A further criticism by plaintiff's counsel of the capitalization of the whole earnings is that it is immaterial that the company's whole revenues are adequate, if it be shown that the retail rates are too low, that the latter rates alone are under investigation. Of course, protestants submit, and the Commission takes the view, that all of the rates both wholesale and retail are subject to regulation. *Protestants further submit that there is no inadequacy either in the wholesale or retail revenues.* (Brief, p. 185.)

Protestants deny the application to this case of Northern Pacific Railway Co. v. North Dakota, 236 U. S. 585, and Norfolk & Western Railway Company v. West Virginia, 236 U. S. 605. The cases are doubtless well known to the court and we, therefore, will say nothing concerning their facts except that they hold that no Commission or legislature, without regard to the full rate structure of the company involved may single out one great class of business such as the passenger service, or the coal carriage service of a mid-western railway and reduce the compensation from that class of business to the point

where the return thereon is *less than the cost or merely nominal*. While the West Virginia Commission has not yet exercised its right to fix a schedule for wholesale rates it in effect has indirectly regulated the entire rate structure when it considered the revenues from the wholesale service in fixing the retail rate schedules. It is an entire rate structure that is before this court. It is just here that the case differs materially from Northern Pacific R. R. Co. v. North Dakota

> "The court, therefore, is not called upon to concern itself with mere details of a schedule; or to view a particular tariff or schedule which yields substantial compensation for the service it embraces, when the profitableness of the state business as a whole is not involved.
>
> "But a different question arises when the State has segregated a commodity, or a class of traffic, and has attempted to compel the carrier to transport it at a loss or without substantial compensation even though the entire traffic to which the rate is applied is taken into account. On that fact being satisfactorily established, the presumption of reasonableness is rebutted."
>
> Northern Pacific Ry. Co. v. North Dakota, 236 U. S. 585, 599

It is an entire rate structure, not a separate investigation of a retail rate schedule, which was before the Commission and is now before this court.

In the main brief (p. 173) protestants cited the case of Willcox v. Consolidated Gas Company, 212 U. S. 19, as an authority directly in point. The complainant attempted to enjoin the enforcement of gas rates fixed by the legis-

lature of New York on the ground that they were confiscatory. A further claim was that there was discrimination between the rates charged the City of New York and individual consumers. On this point the court said:

> "Lastly, it is objected that there is an illegal discrimination as between the city and the consumers individually. We see no discrimination which is illegal or for which good reasons could not be given. But neither the city nor the consumers are finding fault with it, and the only interest of the complainant in the question is to find out whether, by the reduced price to the city, the complainant is upon the whole unable to realize a return sufficient to comply with what it has the right to demand. What we have already said applies to the facts now in question.
>
> "We cannot see from the whole evidence that the price fixed for gas supplied to the city by wholesale, so to speak, would so reduce the profits from the total of the gas supplied as to thereby render such total profits insufficient as a return upon the property used by the complainant. So long as the total is enough to furnish such return it is not important that with relation to some customers the price is not enough."

The Supreme Court of West Virginia announced precisely the same principles in Pittsburgh & West Virginia Gas Co. v. Public Service Commission, 101 W. Va. 63, 72.

THE RETURN FROM THE WEST VIRGINIA RETAIL BUSINESS

The return from the West Virginia retail business is fully stated and explained in the main brief. (P. 173, *et seq.*) We there undertook to show that the retail bu i-

ness paid more than its share of revenue to the plaintiff. The one point desired to be made here is to refute unequivocally the statement of opposing counsel in oral argument that the so-called parent company adjustment enters into the calculation of the earnings from the retail business in the state. That argument is founded on a misunderstanding of the facts. Whether or not the parent company revenues should be adjusted, they are a part of the *wholesale*, not the retail, business, and protestants have not considered any part of the wholesale earnings in their calculation of the West Virginia retail revenues.

PROPRIETY OF CHARGING DELAY RENTALS TO OPERATING EXPENSE

At the hearing in November, 1927, at least one member of this court expressed some surprise at protestants' position that the annual outlay of the plaintiff for delay rentals should be treated differently from any other item of operating expense. As this outlay amounted to $589,186 (R. 1276) for the year 1925 it is important that protestants' position in regard thereto be made perfectly clear. Briefly stated, it is this: If plaintiff is to be allowed the appreciated value of its lease rights in the rate base, the delay rentals which represent the cost of keeping those rights alive should not be carried as an operating expense. *Plaintiff insists upon considering the lease rights as part of its capital assets to the same extent as if it were seized of the gas underlying the leases in fee simple.*

Protestants maintain that if plaintiff is to be considered as owning the gas, the cost of securing and preserving such gas cannot be deemed an operating expense. Protestants claim that the plaintiff company had no right to deduct this sum of $589,186 from gross earnings in calculating its net profits. The Commission allowed this item of delay rentals as an operating cost, consequently, in determining the value of plaintiff's property

upon which it is earning a fair return by the method of capitalizing its net earnings at 8% (as the protestants have done) this item of delay rentals should be added to the net earnings found by the Commission, and the effective amount resulting from the capitalization of the whole sum would constitute the effective rate base. Wherever protestants have taken this item into account in their tabulations, the calculations have proceeded upon that theory. The annual delay rental in no sense represent a maintenance charge; they constitute an essential cost of creating the rights which plaintiff contends should be treated as absolutely owned by it.

ADJUSTMENT OF GASOLINE EARNINGS

During the first argument of the case one member of this court inquired in substance why, if the manufacture of gasoline is but an incident to the gas industry, all of the earnings from such incidental business should not be added to the earnings from the gas. As pointed out in the main brief (P. 23) this was the position which was taken by the protestants in the earlier hearings. The following table shows what the results would be if it were adopted now:

Net earnings available for depletion, depreciation and return, after including only one-half of gasoline net earnings (R. 1161 and protestants' brief, page 19)	$	5,694,229.00
Add—remaining 50% of gasoline net earnings for 1923 (R. 1158)		934,393.00
Total net earnings including all of gasoline earnings	$	6,628,622.00
Effective valuation of plaintiff's whole property on 8% capitalization basis	$	82,858,000.00
Present Fair Value Alleged in Plaintiff's bill (R. 7)	$	64,621,000.00
Add—Gasoline plant and equipment at cost of reproduction less depreciation (R. 225)		2,399,561.00
Total including Gasoline Plant	$	67,020,561.00

PLAINTIFF'S VALUATION OF THE GAS RESERVES

Accepting, for the purpose of the argument, plaintiff's contention that the gas reserves must be included in the rate base, protestants maintain as fundamental in this case that there can be no valuation approved for the gas

reserves that will result in a computed cost for the gas produced therefrom that is in excess of what the record shows to be the fair and generally accepted market price for gas in the field. The plaintiff's own witnesses show that the fair market value of gas delivered in the field is approximately 10 cents per M cubic feet. Out of this market value the owner of the gas must pay the lifting cost and other operating expenses and the remainder represents the value of the gas under ground, from which the owner's particular reserve may be shown to have either a large or small value. The estimated cost of gas in the field can never exceed this generally accepted market price, for if it did, obviously it could not be sold. Therefore, any valuation theory that produces a higher cost of gas to the public than the fair market price of gas is an erroneous theory.

The above proposition becomes very significant when applied to the valuation estimates of the plaintiff's witnesses. The following table shows what the fair market value for gas in the field would have to be in order to support Mr. Uebelacker's valuation of $36,449,176:

VALUE OF GAS IN THE GROUND IF MR. UEBELACKER'S VALUATION FOR ACREAGE IS TAKEN AS A BASIS

	Annual Amount	Cents per M cubic feet based on 1923 consumption of 47,040,235 M cubic feet
Return of 8% on value of leaseholds ($36,449,176) fixed by Uebelacker Exhibit 1—R. 537	$ 2,915,934	6.199
Amortization of Proven (and probable) Acreage per Uebelacker Exhibit 5—R. 575	1,868,524	3.997
Amortization of Unproven Acreage per Uebelacker Exhibit 5—R. 575	299,432	.637
Operating Expenses applying strictly to Leaseholds per Uebelacker Exhibit 5—R. 582		
Leasehold Expense	48,702	.104
Rentals on Unoperated Leaseholds	628,523	1.336
Well Royalties	*	
Total Fixed Charges and Operating Cost Applying Strictly to Leaseholds	$ 5,761,115	12.273**
Lifting Cost per M cubic feet Uebelacker Exhibit 1—R. 526		5.431
Total Cost which should be comparable with fair market price of gas in field		17.704

*Included by Mr. Uebelacker in lifting costs below. See R. 523.
**This cost compares with a fair market value for gas in the ground of 5 cents, according to Mr. Uebelacker's own estimates.

These figures show that in order to support a valuation of $36,449,176 for the acreage, the company is charging the consumers the equivalent of 17.704 cents per M. cubic feet for gas *in the field*, yet the testimony offered by the plaintiff shows a value of but ten cents. (Five cents value in the ground plus lifting costs). Mr. Uebelacker's conclusion from all the evidence is that the gas in the ground is worth five cents per M. cubic feet (R. 535). On the basis of his total valuation of $36,449,176, however, the value of the gas *in the ground* would be 12.273 cents per M. cubic feet. The conclusion must follow that the estimate of Mr. Uebelacker is destroyed by his admitted valuation of five cents per M. C. F. for the gas in the ground, a valuation which protestants think is at least two cents too high (Brief, p. 146). Mr. Davis arrived at approximately the same valuation, though by a different method.

THE "MERCHANT" THEORY

Counsel for plaintiff in oral argument last November stated that the company is more than a service company, that it is "primarily a merchant", that it is selling a certain commodity, namely, natural gas. Protestants are in complete accord with this characterization of plaintiff's business. It is the same idea which prompted Judge Rose to suggest the theory which we have termed in the brief the "gas purchased" theory (Brief, p. 146). Other merchants in selling goods expect a price sufficient to meet the cost of the units of merchandise as they are sold over the counter together with a fair return upon their equipment and labor, a return which they designate as profit. Why should plaintiff expect more? Or, as Judge Rose puts the issue: Why should plaintiff who owns the gas be treated differently from another company which buys gas and distributes it, charging the cost thereof to its operating expenses? As stated in the main brief, Mr.

Hagenah anticipated the court in the development of this solution of the case. His exhibits 7 and 7-A (R. 1224) show the results for the West Virginia retail business on the basis of substituting the value of the gas in the ground in the operating expenses at the rate of five cents per thousand cubic feet. He eliminated all annual expense items relating to the leases from operating costs and gave the gas rights no place in the rate base. In short, he assumed that the gas reserves were owned by parties entirely disassociated from the plaintiff. However, in the exhibits referred to Mr. Hagenah assumes that the value of five cents in the ground also covers the privilege to the purchaser of extracting the gasoline, while Mr. Uebelacker contends that the value of five cents is exclusive of the extraction privilege; in other words, that the seller on this basis would be entitled to extract the gasoline and still sell the gas at five cents per M cubicfeet.

Our purpose is to show that upon the merchant theory every point of controversy as to the value of the gas in the ground, including Mr. Ueblacker's contention as to the gasoline, can be conceded to the plaintiff, and the latter will still earn a reasonable return from its West Virginia retail business. We do this by adjusting Mr. Hagenah's exhibit shown in the brief at page 164 so as to deduct from the net earnings the revenue from gasoline. The following table is the result:

Net Earnings from West Virginia retail business available for depreciation, amortization and return per table opposite page 164 of Protestants' brief—See also R. 1224	$1,285,736
Deduct Portion of Gasoline Net Earnings assigned to West Virginia retail business—R. 1161	234,626
West Virginia retail business before considering any gasoline credits	1,051,110
Less West Virginia portion (29%) of Depreciation shown by the record to have actually been sustained over 14½ year period ($203,463.—R. 128)	59,004
Net Earnings available for Amortization and Return	992,106
Fair Value (of property exclusive of leaseholds) for West Virginia retail business on which amortization and return are earned at 11.65 per cent	$8,515,931

It will be seen from this table that after including in the operating expenses an item of five cents per M. cubic feet for all gas produced during the year, and after eliminating entirely from consideration the gasoline question, the adjustment for sales to parent companies and the question whether amortization should be calculated upon cost or present value, that is, accepting the latter basis as the proper one, the company is earning in its West Virginia retail business $992,106. Accepting Judge Rose's percentage of 11.65% for return and amortization, the plaintiff is in position to amortize and earn a return upon a fair value of $8,515,931, for all its property used in the West Virginia retail business, except its gas rights. The table at page 180 of the main brief shows that this sum is equivalent to a value of from $25,000,000 to $26,000,000 for

the physical property, $990,000 for working capital and $3,000,000 for going value. No higher values can be sustained upon the record.

If the protestants' view that gas in the ground is worth only 3 cents per M. cubic feet after the gasoline has been extracted be adopted, the net earnings from the West Virginia retail business before deducting for depreciation and amortization would be 1,285,736. (Brief p. 164.) Deducting $59,004 for depreciation and capitalizing the remainder $1,226,732, at $11.65%, there results an effective valuation for the physical properties devoted to the West Virginia retail business of $10,529,888.

It seems inescapable that the "merchant" or "gas purchased" theory is a logical and constructive way to meet the questions presented in a natural gas rate case where the utility is in the business of producing as well as selling natural gas. In this connection the very recent case of *Re* American Indian Oil & Gas Co., decided by the Oklahoma Corporation Commission in March of this year has particular significance. As this decision is not yet available in a bound volume a considerable part thereof is included as a supplement to this brief.

Respectfully submitted,

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October 12, 1928.

SUPPLEMENT

Excerpt from *Re: American Indian Oil & Gas Co.*, P. U. R. 1928C, page 815.

There has been much contention between counsel on both sides of this case as to the proper method or manner of ascertaining the value of the gas leases and wells, or the value of the gas to be used by the public. It is contended by the attorneys for the consumers that the only method heretofore approved by the courts is that the Commission should find the value of the leaseholds, including the wells and equipment used thereon, and that a rate should be predicated upon that value, which would make a return upon the investment, allowance for proper depletion of the gas in the field, and proper depreciation of the equipment. The attorneys for the applicant do not contend that the above is not a proper method of determining the rate basis as to the gas, leases and gas properties, but that that method is not exclusive. They further contend that where gas at the mouth of the well has an established and independent market, and a value other than that fixed by the rate sought to be prescribed by the Commission, that the property can be more accurately valued by using the market value per thousand cubic feet of gas at the well. In other words, applicant contends that when the unit of value or yardstick is detrmined, that the leases and wells thereon can never have a greater or lesser value than the amount of gas it will produce at the unit price.

However, for the Commission to undertake to fix a market value of the gas field by using the unit price of gas, and the estimated amount of gas in the field, would be speculative, first, as to the actual amount of gas in the field, and second, as to the amount of recovery under special or particular conditions that may be different in gas fields, and the probable life of the gas field, all of which is taken into consideration by the purchaser in fixing a market value of the field.

In this case the applicant does not contend that it has any reserve leases being held for the use of the public upon which it seeks a valuation to be considered by the Commission in establishing a rate in this case. Hence the Commission in this case will not attempt to, nor consider, the fixing of a fair market value of the leaseholds, wells, and equipment thereon, or the expense of operating the same, but will fix a market value of the property or gas of the applicant that is actually being used.

The opinion of Judge Woodrough in the application for injunction in the Federal Court, in discussing this phase of the controversy, said:

> "But the Master finds that the whole basis of rate fixing by the Commission is unjust and tends to confiscation, and that an entirely different basis ought to be adopted which might be briefly described in this way: In this and other natural gas rate fixing cases the Commission treats a utility company that serves natural gas to the public as though it were a water company serving water from a stream. In such water utility cases no value need be put on the water itself either in the stream or in the pipes. The utility company need only be compensated for its riparian properties, equipment, and service. Similarly in this and other natural gas cases the Commission ascribes no value to the gas at the well head and values only the utility's interest in the land abutting upon the gas pool, its equipment, and service. The Master finds that the gas itself when it has been captured by the utility company and brought to the well head is a valuable merchantable commodity, the property of the company, which ought not to be taken for public use without fair compensation. He finds that in this case the proof is clear that there is an actual sale value for this company's gas

at its well heads of at least 7½ cents per million cubic feet with willing purchasers at hand ready to buy. He concludes, therefore, that any system of valuation for rates which results in compelling plaintiff to distribute its gas to the public for less than it is demonstrably worth, is wrong.

> "I agree with the Master and am satisfied that those who capture natural gas and have it at their well heads with demonstrable market value must be protected as other owners of the property, and cannot lawfully be compelled to deliver it to the public without just compensation."

The question now necessarily arises, when does gas become property so as to come within the above rule. The decisions of the courts are without exception that gas, when reduced to possession, is a commodity; that gas, when reduced to possession, is property; that when reduced to possession, the owner has the same property right therein that he would have in a ton of coal or a cord of wood.

In the case of West v. Kansas Nat. Gas Co., 221 U. S. 229, 255, 55 L. Ed. 716, 31 Sup. Ct. Rep. 564, the Court said:

> "Gas, when reduced to possession, is a commodity; it belongs to the owner of the land; and when reduced to possession, is his individual property, subject to sale by him, and may be subject of intrastate commerce and interstate commerce."

Again:

> "Natural gas is as much a commodity as iron ore, coal, or petroleum or other products of the earth, and can be transported, bought, and sold as other products."

The Court further says:

> "It is not a commercial product when it is in the earth, but becomes so when brought to the surface and placed in pipes for transportation."

In this case the undisputed testimony is that the applicant can sell its gas after it is captured, and in the pipeline at the mouth of the well, for 9 cents per thousand cubic feet, and this market is for private or independent uses, other than the use in the city of Poteau and vicinity. In other words, the market value of this gas, as established in this case, does not depend upon the rate or the market in Poteau.

Section 7934 Compiled Oklahoma Statutes, 1921 confers jurisdiction and authority upon the Commission to fix the value of gas at the mouth of the well, where a pipeline purchaser and an independent producer may disagree as to the price which the purchaser should pay. The Commission has heretofore exercised this authority and fixed the price at the well which the pipeline should pay the producer of gas after the gas was captured. The Commission in fixing a rate, could not fix a basis lower for the company's own gas than the rate which it should pay for other gas in the same vicinity or adjoining territory.

The finding of the value of gas at the well, and basing the rate thereon was before the Commission in the case of *Re* Western Nat. Gas Co. to increase gas rates, decided December 31, 1918, reported in P. U. R. 1919 B, 76, wherein the Commission said:

> "The best way of securing an equitable natural gas rate adjustment is to separate the producing from the distributing end of the business, allow a reasonable price for gas at the wells; determine the expenses necessarily incurred in gathering, transporting, and distributing gas, determine the depreciation of the property and the amount neces-

> sary to make a rasonable return upon the investment in the property used and useful; and use these factors as a basis for determining equitable rates."

On page 79 in the body of the opinion, the Commission says:

> "By using an estimate of 6 cents per thousand cubic feet, the estimate given by various public service corporations, and found by the Commission to be reasonable, for the cost or value of natural gas at the well, and allowing line losses and expenses which are unavoidable in gathering, transporting and distributing natural gas, it is apparent that 10 cents per thousand cubic feet is the minimum at which gas can be sold at Checotah and Eufaula, without loss to the company. On the record before the Commission, the present rate schedule will not be disturbed, except in so far as the minimum is concerned. Gas can no longer be sold below 10 cents per thousand cubic feet."

In the above case the Commission did not attempt to find the value of the leaseholds, as indicated in the opinion, for the reasons therein stated, but did find the value of the commodity at the mouth of the well used by the public, observing the distinction between the speculative or market value of the leases, and the market value of the commodity which was actually being used from day to day.

Judge Woodrough, when this same matter was pending in the Federal Court, approved the findings and recommendations of the Master, wherein the Master said:

> "The Master finds that the gas itself when it has been captured by the utility company and brought to the well head is a valuable merchantable commodity, the property of the company, which ought

not to be taken for public use without fair compensation. * * *"

I agree with the Master and am satisfied that those who capture natural gas and have it at their well heads with demonstrable market value must be protected as other owners of property and cannot lawfully be compelled to deliver it to the public without just compensation.

The undisputed evidence in this case is that the market value of this gas at the mouth of the well is 9 cents per thousand cubic feet, assuming that there will be some additional expense in operating the wells, the Commission finds and fixes the market value of the gas at the well on the leases of the American Indian Oil & Gas Company at 8 cents per thousand cubic feet.

The Commission will, therefore, in determining the proper rate to be charged for the sale and distribution of natural gas in the city of Poteau by applicant company, do so upon the basis of a market value of the gas produced by applicant, of 8 cents per thousand cubic feet for all gas sold and delivered in the city of Poteau and vicinity, upon the basis, in so far as the transmission and distribution system is concerned, of a value of that property of $115,910.

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UNITED FUEL GAS COMPANY,
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THE PUBLIC SERVICE COMMISSION
OF WEST VIRGINIA, et al.,
Appellees.

BRIEF ON BEHALF OF THE PUBLIC SERVICE COMMISSION OF WEST VIRGINIA, IN REPLY TO THE BRIEF ON BEHALF OF APPELLANT.

F. M. LIVEZEY,
Attorney for Public Service
Commission of West Virginia.

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In the

Supreme Court of the United States

OCTOBER TERM, 1927

Number 79.

UNITED FUEL GAS COMPANY,
Appellant,

vs.

THE PUBLIC SERVICE COMMISSION OF WEST VIRGINIA, et al.,
Appellees.

BRIEF ON BEHALF OF THE PUBLIC SERVICE COMMISSION OF WEST VIRGINIA, IN REPLY TO THE BRIEF ON BEHALF OF APPELLANT.

STATEMENT OF CASE

For convenience, the appellant will be hereinafter referred to as "gas company," the Public Service Comission of West Virginia, one of the appellees, as "the Commission," and the City of Charleston, the City of Huntington, and other intervenors, as "the protestants."

On behalf of the Commission it is desired to correct and supplement the history of the case and the statement of facts as contained in the brief on behalf of appellant, in the following particulars:

The date of the order of the Commission granting the gas company an increase of five cents per thousand cubic feet for gas sold, referred to on page 2 of brief on behalf of appellant as having been made on February 20, 1923, was not made by the Commission until August 9, 1923. (R. 158.)

It is to be observed from statement in the brief of appellant and from the record, that the Columbia Gas & Electric Company and the Ohio Fuel Supply Company own, respectively, 51 per cent and 49 per cent of the capital stock of the United Fuel Gas Company. The gas company has for several years been selling gas in enormous quantities to the Columbia Gas & Electric Company and the Ohio Fuel Supply Company, hereinafter referred to as the "parent companies," and other distributing gas companies, at wholesale rates. The rate charged to the parent companies, however, has been very low. In all the previous proceedings before the Commission, in ascertaining the earnings of the gas company the Commission has made an adjustment in the earnings by adding thereto a sum estimated to represent the difference in the amount received by the gas company from its parent companies for gas so sold, and the amount it would have received if such gas had been sold to independent companies. In the opinion resulting in the

order of August 9, 1923, the Commission estimated that the earnings of the gas company should be adjusted on account of the sale of gas to parent companies by increasing such earnings at least one million dollars. It appeared in such proceeding that the gas company was at that time selling gas at wholesale rates to the Hope Natural Gas Company and the Pittsburgh & West Virginia Gas Company, and that if the gas company had charged its parent companies the same rate as it charged the Hope Natural Gas Company and the Pittsburgh & West Virginia Gas Company it would have received from the parent companies for gas sold them in 1922, $1,463,398.93 more than under the contract rate. Upon appeal to the Supreme Court of Appeals of West Virginia by the City of Charleston and others, pursuant to statute, the Court held that the Hope Natural Gas Company and the Pittsburgh & West Virginia Gas Company in practical effect enjoyed no special advantages over the two parent companies, and hence, that the parent companies should pay as high a rate as the two former companies, and that, therefore, the earnings of the gas company for the year 1922 should be adjusted by an increase of $1,463,398.93 instead of an increase of $1,000,000.00, as determined by the Commission.

From the year 1916 until May 1, 1922, the gas company treated the gas transported through its mains for the purpose of producing gasoline, which process resulted in a rather large earning to the company. During that period the Commission, in considering rate cases before it involving rates of the United Fuel Gas Company, as well as other gas companies, held, with respect to such gasoline business, that the reason-

able value of the use of gas for the purpose of the manufacture of gasoline should be credited to the gas expense and allocated between the wholesale and retail departments, and between localities, on the basis of sales, and that such reasonable value should be fixed at one-half the net earnings arising from the manufacture of gasoline.

On May 1, 1922, the gas company caused to be organized the Virginian Gasoline & Oil Company, to which was conveyed by the gas company its gasoline business, including certain gasoline stations, the lands upon which they were located, tank cars and gasoline on hand, and all of the company's oil interest in certain operated and unoperated acreage in West Virginia and Kentucky, in consideration of the Virginian company assuming the payment of certain bonds of the gas company, and the issue and transfer of 8,899 shares of its capital stock to the gas company, which stock was subsequently transferred to the parent companies in proportion to their stock holdings in the gas company. On the same day the gas company entered into a contract with the Virginian Gasoline & Oil Company, which will be hereinafter referred to as the "gasoline contract," and which provided that the Virginian company should have the exclusive right of extracting gasoline from the gas transported through the gas company's lines, for which right the Virginian company agreed to pay the gas company a royalty of one-eighth of the gross proceeds of sale of gasoline produced by it from the gas company's gas. In the proceedings resulting in the order of the Commission of August 9, 1923, it was contended by the gas company that the gasoline contract was a fair one, that there

was an adequate consideration therefor, and that one-eighth of the gross revenue was fair compensation to the gas company for the privilege thereby granted. The majority opinion of the Commission sustained this contention. It appeared that one-eighth of the gross revenue from the sale of gasoline produced under the privilege was very much less than one-half of the net proceeds of the sale of such gasoline. On appeal to the Supreme Court of Appeals of West Virginia it was held that the reasonable value of the use of natural gas of a public service company for the purpose of the manufacture of gasoline therefrom, as shown in such case, was one-half of the net income derived from the production and sale of such gasoline, and that the transfer from the gas company to the Virginian Gasoline & Oil Company and the gasoline contract should be ignored in the rate case before the Commission. The Court's opinion in such case, as stated in appellants' brief, is reported in 95 W. Va. 91, and 120 S. E. 398, and from an examination of which it will be seen that the reversal in such case was not based alone on the insufficiency of the evidence with respect to the value of the gas company's gas rights.

The Commission and other defendants named in the bill filed by the gas company in the District Court of the United States for the Southern District of West Virginia, filed their answer to said bill. By reference to the eleventh clause of the bill of complaint (R. 18-22) it will be seen that the gas company complains that in determining the gas company's net income for the year 1923, the Commission added to the actual income of the plaintiff the sum of $2,143,661.46, being the

difference between what the gas company charged its parent companies for gas sold to them and what the Commission thought should have been charged, and also by adding the further sum of $934,393.41, representing one-half of the net profits from the manufacture of gasoline for the year 1923. In the answer filed by the Commission (R. 145, et seq., 157) it is alleged that such issues have been before the Commission heretofore, and were before the Commission in the case resulting in the order of August 9, 1923, which was appealed by certain protestants to the Supreme Court of Appeals of West Virginia, and, as hereinbefore stated, that court held that in ascertaining the revenues of the gas company the two parent companies should be required to pay as high a rate as other independent companies paid for the purchase of gas under similar conditions and circumstances, and that at least fifty per cent of the net profits from the gasoline business should be included in the net earnings of the gas company, notwithstanding the transfer to the Virginian Gasoline & Oil Company and the gasoline contract hereinbefore referred to. The Commission and other defendants named in said bill, therefore, answered that the issues with respect to the proper method of the treatment of the gas company's revenue in connection with gasoline earnings and the sales of gas to parent companies have been fully and finally determined by the Supreme Court of Appeals of West Virginia by its order and decision made on the 27th day of November, 1923, in the case therein known as The City of Charleston, et al. vs. Public Service Commission, et al., and in which said proceeding the gas company was one of the appellees and in privity with the Commission, and in which said appeal

and proceeding the issues, evidence and exhibits with respect to the questions aforesaid were identical with the issues, evidence and exhibits in the subsequent proceeding before the Commission, and in which the order of March 24, 1925, was made, and of which the gas company is now complaining, and that by reason thereof such issues have become, and are, as to the parties hereto, *res adjudicata*. (R. 159-160.)

The Commission and other defendants named in said bill further answered and denied that the order of the Commission of March 24, 1925, denying the gas company any increase in rates was, or is, confiscatory, or that the same resulted in a taking of the gas company's property without just compensation, in violation of the Fourteenth Amendment to the Constitution of the United States.

As stated in appellants brief, there is little or no dispute as to any matter of fact. But, there are substantial differences in the application of economic and legal principles. The gas company's property, the present fair value of which constitutes the basis for rate making, aside from going value and working capital, is classified as "production, transmission and distribution systems." With respect to the values fixed by the Commission and the court below for the property embraced in these systems, there is no substantial complaint except as to the value given to gas rights which are embraced in the production system. On these gas rights the company claims a value of more than $36,000,000.00. Commissioner Stathers fixed the value of $6,361,511.42, and Commissioner Divine fixed a value of $10,500,000.00, both of whom concurred in the order denying the gas company any increase in

rates, while the court below held that the value of such rights presently used and useful in the public service was not in excess of $10,317,311.39.

Such gas rights consist of certain rights in 814,910.68 acres, situate mostly in West Virginia, and a small part thereof in Kentucky, and of which the gas rights in 41,969.47 acres are owned in fee, and the remainder is held under written leases. This acreage is classified by witnesses on behalf of the gas company as 68,900.72 acres "operated," that is, on which there are producing wells, and 746,009.96 acres as "unoperated," that is, on which there are no producing wells. Said acreage is further classified by such witnesses as "proven acreage," that is, in which the existence of gas has been shown, and "probable acreage," that is, acreage which will probably produce gas, and "possible" and "unfavorable" acreage. The proven acreage is estimated at 136,384 acres, of which 114,784 acres have been tested, and 21,600 acres not tested. The probable acreage is estimated to be 126,208 acres, and the possible and unfavorable acreage 552,318.68 acres.

The territory subject to lease is covered by contracts of lease containing, respectively, various and sundry provisions as to initial consideration, term, rentals and royalties. The greater part of such leases provide that, in consideration of an initial payment, ranging from 25 cents to one dollar per acre, the lessee shall have the right to explore for oil and gas on the premises for a term ranging from one to ten years, and as long thereafter as oil or gas is produced in paying quantities, by the payment of an annual rental of so much per acre, ranging from 25 cents to one dollar,

called "delay rental," until oil or gas is found, and thereafter a proportion of the oil produced, usually one-eighth part, and so much per annum for each producing gas well, usually $300.00 per well per annum, with the right to the lessee to abandon and surrender such leases, for a nominal consideration, at any time before oil or gas is discovered. Under these leases the lessee acquires no vested interest in the gas until it is discovered.

It has been the uniform practice of the gas company to charge the initial or cash payments made for such leases to capital account, and subsequent carrying charges, including delay rentals, are charged to operating expense.

In 1909 the United Fuel Gas Company acquired all of the leases and other property of the Hope Natural Gas Company in southern West Virginia, and all of the leases and other property of its predecessor, the United Fuel Gas Company, and of the United States Natural Gas Company. The acreage thus acquired was 1,056,443.58 acres, for which a value was assigned on the books of the purchasing company of $7,233,538.96. This value was fixed without regard to the cost or investment in such acreage. From July 1, 1909, to December 31, 1923, the gas company acquired an additional acreage of 1,100,887.09 acres through gas property purchased and leases acquired. During the same period it surrendered, abandoned, or otherwise disposed of, 1,342,419.99 acres, leaving within its control on December 31, 1923, said 814,910.68 acres. The actual book cost of such acreage was less than $2,000,000.00, but, due to the appraisal or value assigned thereto at the time of purchase in 1909, or

soon thereafter, the cost as shown upon the company's books as of December 31, 1923, was $6,343,329.67. (R. 116.) This figure, adjusted to include additional acreage acquired and surrendered to November 30, 1924, is found to be $6,361,511.42, being the value assigned to such gas rights by Commissioner Stathers. (R. 117.)

Of course, the issue presented by the plaintiff's bill is, Are the rates permitted by the order of the Commission confiscatory? Determination of such issue involves the ascertainment of the fair value of the property of the gas company and its earnings. If the earnings under the present rates are sufficient to afford a reasonable return on the fair value of its property, then it would not be entitled to relief as prayed for in the bill, no matter what errors may have been committed by the Commission, or what discriminations may result from the Commission's order. Consequently, the record before the Commission was not to be reviewed by the court below for error as upon writ of error, appeal or certiorari.

From what has been said, and what will be hereinafter shown, the main questions to be determined are, (1) What is the fair value of the gas company's gas rights, used and useful in the public service? (2) What is the proper method of treating the earnings of the gas company from the gasoline business? (3) In ascertaining the earnings of the gas company, should it be required to account for gas sold to its parent companies on the same basis as sales made to other independent distributing companies?

ARGUMENT

SUMMARY

I. Fair value of gas company's property used and useful in the public service.

(1) The gas leases constituting the greater part of gas rights and properties are chattels real, but do not give any vested right in the gas in place until after discovery and extraction.

(2) The value of such gas leases is not the sales price per cubic foot of the estimated quantity of gas in a given field, but the value of the leases.

(3) The value of gas rights is not in excess of $10,500,000.00, and the only competent proof before the Commission or the court below as to such value is the book cost, which to November 30, 1924, was $6,361,511.42.

(a) *Evidence on behalf of gas company speculative and unreliable.*

(b) *Burden on gas company to show fair value.*

(4) Gas rights should be included in valuation as rate base only to the extent that they are used and useful in the public service.

(5) There can be no substantial complaint as to the value fixed by either the Commission or the court below as to the gas company's tangible or physical property, going concern value and working capital.

(6) The court below did not err in not including in the value of the tangible or physical property the sum of $2,044,778.24 on account of new investment in such property added and put in use during the year 1924.

(a) *The court below used the value as of December* 31, 1923, *and the earnings for the calendar year* 1923 *in in the calculation for the purpose of ascertaining the return afforded.*

II. The value of the gas company's property used in the service of its domestic and industrial consumers within the State of West Virginia was not more than $11,251,499.00.

III. The allowance of 3.65 per cent per year of the value of the gas company's property was a generous allowance for amortization.

IV. In adjusting the earnings of the gas company for the year 1923, the commission and the court below added to the earnings as reflected by the company's books the sum of $2,143,661.46 (not $1,495,-496.69) on account of sale of gas to the parent companies.

(a) *This adjustment is equitable and proper.*

(b) *Adjustment in accordance with former adjudication by the Supreme Court of Appeals of the State of West Virginia.*

V. The commission and the court below adjusted the gas company's earnings for the year 1923 by adding thereto the sum of $934,393.41 on account of gasoline earnings.

(a) *This adjustment is proper and equitable.*

(b) *Adjustment is in accordance with former adjudication by the Supreme Court of Appeals of the State of West Virginia.*

VI. The rates complained of in the bill are sufficient to produce a fair return on the value of the gas company's property, and such rates are, therefore, not confiscatory.

VII. The order of the District Court refusing an interlocutory injunction should be affirmed.

ARGUMENT

I

FAIR VALUE OF GAS COMPANY'S PROPERTY USED AND USEFUL IN THE PUBLIC SERVICE.

From what has heretofore been said, and an analysis of the values contended for by the gas company, and those fixed by the commission and the court below, it is apparent that the main question is the proper value to be placed on the gas company's gas

rights and leaseholds, and what part thereof are presently used and useful in the public service. It is, therefore, pertinent to first inquire as to the nature of such right.

1. The gas leases constituting the greater part of the gas company's gas rights and properties constitute chattels real, but do not give any vested right in the gas in place.

As heretofore shown, the gas company controls 814,910.68 acres of gas territory, of which 41,969.47 acres are owned in fee, and the remainder is held under lease. While little information was furnished to the commission as to the character, nature and terms of such leases (R. 108-109), an effort was made in the court below to supply such omission by the introduction before the court of specimens of all forms of leases in common use by the gas company (R. 1031-1058), with a tabulation of the acreage held under certain classes of such leases. (R. 1014-1030.) Such leases are obtained for an initial consideration, called a bonus, usually being equal to the first quarterly rental thereunder. The greater number of the leases are for a term of ten years, provide for a delay rental of one dollar per acre per year until a producing gas well is drilled in, when the rental is changed to so much per well per year, usually $300.00. (R. 371.) The right to surrender by lessee for nominal consideration is reserved in all leases. Under these leases the title to the gas remains in the lessor and continues as his property until it is extracted, when the title vests in the

lessee. The only right given to the gas company under its lease is the right to explore for oil and gas and to produce them when found. This is the law of West Virginia.

Headley vs. Hoopengarner, 60 W. Va. 626, 55 S. E. 744.

The decisions of state courts relative to the status of property constitute rules of property, and should be accepted and applied by the Federal Court.

Guffey vs. Smith, 237 U. S. 113, 59 L. Ad. 856; 35 Sup. Ct. Rep. 526.

2. **The value of such gas leases is not the sales price per cubic foot of the estimated quantity of gas in a given field, but the value of the leases.**

Since the lessee acquires no vested right in the gas in place until it is discovered by drilling, and the right to explore therefor being dependent upon compliance with the terms and conditions of the lease, it would seem to follow logically that the gas content in an undeveloped lease would not form the basis of value for such lease. The use of an estimated quantity of gas in the ground as a basis for determining the value of gas leaseholds is attended with so much speculation, uncertainty and varying contingencies as to be of little use.

City of Charleston vs. Public Service Comm'n, et al., 95 W. Va. 91, 120 S. E. 398;

Re United Fuel Gas Co., P. U. R. 1920-C, p. 583.

3. The value of gas rights is not in excess of $10,500,000.00, and the only competent proof before the commission or court as to such value is the book cost, which to November 30, 1924, was $6,361,511.42.

Commissioner Stathers allowed a value on all the gas rights of $6,361,511.42, that being the book cost, on the theory that such was the only competent evidence of value before the commission. Commissioner Divine allowed a value of $10,500,000.00, but it is not quite clear as to just how he arrived at this figure. Both Commissioner Stathers and Commissioner Divine concurred in the order denying the gas company any increase in rates. The court below said that $10,317,311.39 was the highest valuation which could be put upon such portion of the gas company's reserves as it has any claim to include in its rate base. The gas company claims a value of over $36,000,000.00 on its reserves, and that the whole thereof should be included in its rate base.

(a) *Evidence on behalf of gas company speculative and unreliable.*

Since the greater part of appellants gas territory is held under leases which do not give any vested right to the gas in place, and because of the many contingencies involved, it is submitted that estimates of the quantity of gas in territory covered by such leases should not be used as a basis of value.

American Indian Oil & Gas Co. vs. Poteau (Okla.), 235 Pac. 906, P. U. R. 1926-A 236;
City of Charleston vs. Public Service Comm'n, 95 W. Va. 91, 120 S. E. 398.

In the case of City of Erie vs. Public Service Commission (Pa.), 123 Atl. 471, P. U. R. 1924-D 89, the court in its opinion said:

> "The value of the land is not the selling price of a cubic foot of gas as applied to the supposed quantity in a given field; its value is fixed as a whole or at so much an acre."

However, if any weight is to be given estimates of quantity of gas in the ground, some unit value must be applied thereto to arrive at a value for the whole. Such unit value should be ascertained by some dependable measure of experience, and without regard to present earnings of the gas company.

In support of the value claimed for its gas rights the gas company relies upon two classes of evidence: the first, that given by Mr. Ralph E. Davis and Charles F. Uebelacker, both highly technical experts, and the second, that shown by the testimony of T. O. Sullivan, John B. Corrin, T. B. Greggory, John Davidson, and others, as practical and experienced gas men.

The testimony of Mr. Uebelacker appears in the record, page 195 et seq., and that of Ralph E. Davis at page 229, et seq. Mr. Davis arrives at a value for the proven and probable acreage of $32,458,129.17, while Mr. Uebelacker arrives at a valuation for the same property of $33,185,000.00. It is deemed unnecessary

here to detail the method by which these witnesses arrived at such values, for the same is fully detailed in appellant's brief and explained in the record. It will suffice to say that the methods used are based upon theories, speculations and suppositions, which it is submitted form no safe basis for arriving at a value, and which has heretofore been condemned by the West Virginia court.

It should be observed that Mr. Davis, in arriving at his value, assumes that the gas company may dispose of its gas in the most advantageous way and without any restriction or regulation whatever. From the nature of the gas company's business, it is at once obvious that this is an impossibility.

The next class of evidence relied upon by the gas company in support of its claim is that of the witnesses in the gas business. These witnesses give their estimates of the value of the company's gas rights at anywhere from $30,000,000.00 to $45,000,000.00. (R. 279, et seq.) An analysis of the testimony of these witnesses will disclose that their estimates are based upon either the earnings of the gas company or a supposed market for its gas at varying prices. This character of testimony has heretofore been produced before the commission and was the subject of review by the Supreme Court of Appeals of West Virginia in at least two cases.

City of Charleston vs. Public Service Comm'n, 95 W. Va. 91, 120 S. E. 398;
Natural Gas Co. of W. Va. vs. Public Service Comm'n, 95 W. Va. 557, 121 S. E. 716.

In City of Charleston vs. Public Service Commission, *supra*, the testimony of Ralph E. Davis, of a character similar to that before the commission and before the court below, was the subject of review by the Supreme Court of Appeals of the State of West Virginia, and wherein it was held by the court that his estimates were too uncertain to form a basis for a valuation of the company's leasehold.

In Natural Gas Company vs. Public Service Commission, *supra*, in discussing the testimony of witnesses as to the value of gas leaseholds the court says:

> "Generally speaking, evidence of value in a rate-making case cannot be based upon the rate of return or earnings of the utility; and whenever this appears, either directly or indirectly, such evidence is incompetent. It is almost inconceivable that there can be an open market for these gas leaseholds, situate as they are, which would not be based upon the rates at which the utilities there are selling gas to the public."

With these decisions of its own state court before it, the commission could hardly do otherwise than reject the evidence before it as to appreciated value of appellant's gas rights. It is said, however, that the evidence before the court below meets the criticism of the Supreme Court of Appeals of West Virginia and of Commissioner Stathers. It is submitted, however, that an analysis of the testimony offered before the court below will show that it is of the same general character as that which was condemned by the state court. If, however, the evidence offered in the court below has supplied the omission that was made before

the commission, why should the gas company not be required to first introduce such evidence to the commission before applying to the Federal Court for injunctive relief?

(b) *Burden on gas company to show fair value.*

Section 9, chapter 15-0, West Virginia code, provides, in part:

> "At any hearing involving a rate sought to be increased or involving the change of any fare, charge, classification, regulation or practice, after the passage of this act, the burden of proof to show that the increased rate or proposed increased rate, or the proposed change of fare, charge, classification, regulation or practice is just and reasonable shall be upon the public service corporation making application for such change."

It is therefore submitted that the testimony of the witnesses on behalf of the gas company as to the value of gas rights and leaseholds is subject to the objection that the estimates are all based upon speculation, uncertainties and varying contingencies, so as to make such testimony incompetent and of no value to either the commission or the court in arriving at the present fair value of such property. The burden being upon the gas company, and there being no other competent proof before the commission or the court below other than the book cost of such property, neither the commission nor the court below was justified in including in the rate base a value therefor greater than such book cost.

It is true that the evidence of the witnesses on behalf of the gas company is uncontradicted, and if such testimony when analyzed by proper tests is found to be competent proof, then the value of the company's gas rights and leaseholds is shown in the record to be, according to the estimates of such witnesses, from approximately $32,000,000.00 to $45,000,000.00, and the next pertinent inquiry would be as to what part of such gas rights and leaseholds are presently used and useful in the public service.

4. Gas rights should be included in valuation as rate base only to the extent that they are used and useful in the public service.

In Erie vs. Public Service Commission (Pa.), 123 Atl. 471, P. U. R. 1924-D 89, it was held that:

> "Gas holdings should be included and be evaluated only to the extent that they will be developed, used and useful territory, including a reasonable reserve for the continued functioning of the company in its public service."

In 1909 the gas company had a total gas territory of 1,056,443.58 acres, of which 21,519.99 was operated, and the unoperated acreage was 1,034,923.59. (R. 1085) Of this total acreage, from July 1, 1909, to December 31, 1923, about 1,300,000 acres was abandoned. (R. 1086) As of December 31, 1923, the company had gas territory consisting of 68,900.72 acres operated, and 746,009.96 acres unoperated. During the

period from July 1, 1909, to December 31, 1923, only 55,674.26 acres were transferred from the unoperated to the operated acreage account. (R. 1086) These facts suggest, if they do not prove conclusively, that the entire acreage controlled by the gas company is not presently used and useful in the public service, and that present industrial and domestic consumers of gas should not be required to pay a rate to afford a return upon the whole value of such gas territory, when such territory will not be brought into public service for many years to come. This would seem to be especially true if such gas rights and leaseholds are to be given the greatly appreciated value claimed by the gas company, and, the fact that the actual cost of such property was less than $2,000,000.00, and that the cost of carrying the same has been charged to operating expenses and paid for by such consumers.

The court below taking this view of the case, and accepting Mr. Davis' estimates of value, arrived at the conclusion that the highest valuation which could be put upon that portion of the plaintiff's gas territory which it had any claim to include in its rate base was $10,317,311.39, and arrived at that conclusion by calculation and reasoning stated as follows:

> "Mr. Davis, as we have seen, valued the gas owned by the plaintiff and under the 136,834 of proven territory, operated and unopated at $10,317,311.39. On December 31, 1923, plaintiff was operating only 68,981 acres or 50.58% of these. The total supply of gas under this operated territory calculated according to his methods was then 124,994,780 M. C. F., and was worth, he estimated, $5,218,496.50. There was under the acreage which he classed as proven but not

operated an additional 124,105,220 M. C. F. valued by him at $5,098,814.89. If we are right in our understanding of his testimony, it would perhaps be possible to claim that all of the gas in both classes was tributary to the territory which was in operation, in the sense that the plaintiff was drawing from the pools containing it. It will be noted that the total of the gas underlying the proven acreage was 249,100,000 M. C. F. As the plaintiff sells annually about 47,000,000 M. C. F. of which 10,500,000 goes to the West Virginia retail purchasers, it has under its proven territory gas enough for everybody for more than five years and an amount sufficient to meet the needs of its public service patrons alone for almost a quarter of a century."

Counsel for appellant say that such conclusion of the court below is contrary to the holding of the Supreme Court of Appeals of West Virginia in the case of City of Charleston vs. Public Service Commission, 95 W. Va. 91, 120 S. E. 398, in that the state court held that the company was entitled to earn a fair return upon the present fair value of all gas reserves. It is submitted that an analysis of the opinion of the state court will show that such question was not considered or decided.

It is also said that the gas company could not build its present plant on the basis of only a five years' supply of gas, and that it would be unfair that it should be required to carry such excess territory without return until the same should be brought into the public service.

In reply to the first of these objections, it ought to be sufficient to say that it would be more equitable to require the gas company to wait for a return upon such excess gas acreage until the same is brought into the public service, at which time it could be put in the rate base at a capitalization to include carrying charges as well as appreciation in value, than it is to require present domestic and industrial consumers to carry a return upon an exaggerated appreciated value on something that is not, and will not for many years be devoted to the public service.

The answer to the second objection is this: that the large plant constructed by the gas company has been so constructed with the knowledge that large supplies of gas would be available to it through acreage controlled by it and purchases made from other producing companies, and it is now known to be a fact that such supplies of gas are available, and will continue to be available for the estimated period of eighteen years, or longer. At the present it ought to be sufficient for the gas company to receive a return upon the present fair value of all of its tangible or physical property, and so much of the gas reserves as are presently used and useful in the public service.

The question of the proportion of gas reserves presently used and useful was covered by a memorandum of Mr. Hagenah, a witness on behalf of protestants. (R. 1216-1221) In such memorandum two methods are suggested for meeting the situation, whereby the public, on the one hand, would be protected against excessive rates required to afford a return upon property not presently used and useful, and the gas company, on the other hand, would be pro-

tected in its property rights. The adoption of one or the other of the methods suggested would be a matter of policy for adoption by the gas company and approval by the commission.

5. There can be no substantial complaint as to the value fixed by either the commission, or the court below, as to the gas company's tangible or physical property, going concern value and working capital.

Excluding value of leaseholds, gas rights, working capital and going value, Mr. Uebelacker, engineer, witness for the gas company, estimated the reproduction cost new of the physical property as of December 31, 1923, to be $37,054,425.00, and the reproduction cost new less deterioration at $28,631,320.00. (R. 493 et seq.)

Mr. Hagenah, engineer, witness for protestants, estimated the reproduction cost new of the same property, as of the same date, at $35,391,152.00, and the reproduction cost new less depreciation at $23,969,-180.00. (R. 1163 et seq.)

Mr. Uebelacker estimates the historical cost of the physical property at $25,480,378.33. (R. 553 et seq.)

The book cost as of December 31, 1923, is shown by the testimony of Mr. Jirgal, witness on behalf of the protestants, to be $19,945,582.16. (R. 1059 et seq.)

The difference between the estimates of Uebelacker and Hagenah will be found to be due to difference of opinion in allowance for overheads and depreciation.

Mr. Uebelacker also included in his cost of reproduction $254,332.00 as the cost of drilling dry holes. This the commission disallowed and it is submitted properly so.

As to the physical property embraced in the estimates aforesaid Commissioner Stathers reached the conclusion that the present value thereof, as of December 31, 1923, was $25,000,000.00 and Commissioner Divine adopted as such value the sum of $26,000,000.00.

It was agreed that the amount of $990,000.00 should be added for working capital. The commission allowed for going concern value the sum of $3,000,000.00. The appellant was apparently satisfied with this item with the allowance for going value until the filing of its brief in this court, for an examination of the bill of complaint does not disclose any complaint of the failure to allow more than $3,000,000.00 to cover going value. At any rate it is submitted that the allowance of more than $3,000,000.00 to cover going value would not be justified until a more definite formula or rule is laid down for determining such value by commissions and courts.

It is therefore submitted that the value fixed for the physical property, working capital and going value by the commission, as well as by the court below, finds

ample support in the evidence of record, and that there can be no substantial complaint on this ground.

6. The court below did not err in not including in the value of the tangible or physical property the sum of $2,044,778.24 on account of new investment in such property added and put in use during the year 1924.

(a) *The court below used value as of December 31, 1923, and earnings for the calendar year 1923 in the calculation for the purpose of ascertaining the return afforded.*

In making the calculations for the purpose of ascertaining the return afforded by the rates of the gas company, the court below used the earnings for the year ending December 31, 1923. (R. 1237). In further evidence of this fact, the following is quoted from the opinion of the court below:

> "In our consideration of the case, for income and outgo, we have used the figures for the calendar year 1923."
>
> (R. 1274.)

Had the court included the item of $2,044,778.24 in the valuation of the property as representing the additional investment of property put into use during the year 1924, it would have likewise had to use the

earnings for the calendar year 1924 for the purpose of the computation.

It is therefore submitted that there was no error by the court below in the above particular.

II.

The value of the gas company's property used in the service of its domestic and industrial consumers within the State of West Virginia was not more than $11,251,499.00.

The commission in its opinion did not allocate any separate value to the gas company's property devoted to the public service within West Virginia but after reaching a conclusion as to the present fair value of the company's property and making certain necessary and proper adjustments in earnings and operating expenses, a conclusion was reached that on the whole the company was earning more than a reasonable rate of return upon the value so ascertained. However, the percentages applicable and the methods of allocating the value of the property, earnings and operating expenses as between the classes of consumers and localities served have never been and are not now a matter of serious controversy. The court below simply used such methods and applied such percentage to the values which were determined upon in arriving at the total value of appellant's property of all kinds, used and useful, and thereby ascertained that the value of property used in the so-called regulated business would not

exceed $11,251,499.00. The difference between this latter sum and what the appellant contends for in its brief is due to the main points in difference as to the proper method of valuing the property used and useful in the public service.

It is asserted on behalf of the commission that all of the gas business of the appellant is a public service business and subject to regulation. (Munn vs. Illinois, 94 U. S. 113, 24 L. Ed. 77; 9 Roses Notes, U. S. Rep. 510 et seq.; Clarksburg Heat & Light Company vs. Public Service Commission, 84 W. Va. 638; Carnegie Natural Gas Company vs. Swiger, 72 W. Va. 557; Peoples Natural Gas Co. vs. Public Service Commission, 279 Pa. 252.)

If this proposition be correct and the gas company is earning a sufficient return from its whole business, it would be immaterial what value is to be assigned to industrial and domestic consumers within the State of West Virginia, and what portion of the earnings and operating expenses shall be allocated thereto. In other words if there should be discrimination between classes of consumers resulting in one class paying less than it should, this could not be confiscation and subject to correction by the federal courts.

III.

The allowance of 3.65 per cent per year of the value of the gas company's property was a generous allowance for amortization.

Commissioner Stathers held that the gas company should be allowed 4.15 per cent of the present fair value of the property for amortization, and that for depletion and depreciation there should be allowed 1.12.5 per cent of the book cost. (R. 120-129) In all previous cases involving gas companies before the commission it had been held that the utility was only entitled to amortize the book or investment cost of its property, and not the present fair value thereof, and it is submitted that such holding is supported by very respectable authority.

In the light of the exhibits in the record and the various calculations relating to amortization and depreciation, the court below felt that 3.65 per centum per annum was a generous allowance for amortization, and this conclusion finds ample support in the record, as might be demonstrated by proper analysis. Such demonstration and further discussion of this question, it is felt, will serve no useful purpose if, as is asserted, the appellant is not entitled to include as a part of its rate base the full appreciated value of its gas reserves, and is required to account for gas sold to its parent companies, on the same basis as sales to independent companies, and is also required to account for the earnings from its gasoline business.

In discussing the question of amortization, counsel for appellant, on page 53 of their brief, assert that Commissioner Stathers fell into error by deducting from the rate base of $35,999,969.14 as found by him, in addition to an item of working capital of $990,000.00, the further sum of $14,028,737.03, which latter sum he says is the amount of property already amor-

tized as of December 31, 1923. It is further asserted that the treatment accorded the matter by Commissioner Stathers results in a double deduction, and that the effect thereof is to deprive the appellant of any compensation whatever for gas already sold and delivered to its customers and the depreciation which its plant has already suffered. That the statement contained in appellant's brief is not correct will appear from careful analysis of the opinion written by Commissioner Stathers, especially that part thereof relating to the definition of "amortization," "depreciation" and "depletion." First let it be noted that the treatment of the subject referred to in appellant's brief by Commissioner Stathers does not relate to the ascertainment of the present fair value of the property. Commissioner Stathers accepted Mr. Uebelacker's theory of amortization and depreciation, namely, that the term "amortization" applies to an allowance for the eventual retirement of the present value of the gas rights and the present value of operating plant upon the exhaustion of the supply of natural gas which is essential for its operation; and that the term "depreciation" means simply an allowance for the purpose of compensating the utility for property consumed in the service, but that such allowance for depreciation is in no sense for the purpose of returning the value of the property used in the service at the termination of such use. The allowance for amortization takes care of that. In making an analysis of the books of the company for the period from 1916 to December 31, 1923, Commissioner Stathers ascertained that there had been returned to the company for amortization purposes the sum of $14,028,737.03, and that in addition to this, the company had received by way of de-

preciation allowance during the same period considerably more than it had used.

In Fuhrmann vs. Iriquois Natural Gas Company (N. Y.) P. U. R. 1919-D 76, it was held:

> "The amortization charge against the consumers of a natural gas company should not be confined to the period following a valuation in a rate proceeding, but should be spread over the entire life of the company, both past and future."

Contrary to the holding of the commission in former cases, Commissioner Stathers held that the fair value of the gas company's property was to be amortized, rather than the book cost thereof, and, agreeable to the principle announced in Fuhrmann vs. Iriquois Natural Gas Company, *supra*, he proceeded to ascertain that the unamortized portion of the fair value of the gas company's plant was $20,981,232.11, the other part of such value having been amortized prior to December 31, 1923. Assuming future life of not less than eighteen years, Commissioner Stathers estimated and found that 4.15 per cent of the unamortized portion of appellant's property would provide sufficient amount in each year to amortize the unamortized portion of such property.

The gas company has earned by way of depreciation allowance more than was used for the purpose of taking care of the wear and tear upon the physical plant in the past.

It is, therefore, submitted that the contention of the appellant in the above particular is without merit.

IV.

In adjusting the earnings of the gas company for the year 1923, the commission and the court below added to the earnings as reflected by the company's books the sum of $2,143,661.46 (not $1,495,496.69) on account of sale of gas to the parent companies.

Appellant is apparently in error as to the extent of the adjustment made on account of sales of gas to the parent companies. The commission, in making adjustment of the gas company's earnings on that account for the year 1923, added $2,143,661.46. (R. 132) The detail of this adjustment is explained by Mr. Jirgal, a witness on behalf of the protestants. (R. 422 and 1162) The court below made like adjustment in like amount. (R. 1238)

(a) *This adjustment is equitable and proper.*

Appellant contends that the sale of gas to its parent companies is an unregulated portion of its business, and for that reason such sales of gas are of no concern to the industrial and domestic consumers. First, in reply it is asserted that all of the business of the appellant is subject to public regulation, on the authority heretofore cited. But, without further discussion of that point, it is submitted that the appellant's contention is wholly untenable. The record discloses that the amount of such sale to parent companies for the year 1923 was 17,613,173,000 cubic feet of gas. It

is at once obvious that a very considerable part of the large investment made by the company has been made to supply the parent companies and other wholesale consumers, and it seems only fair that they should bear their share of the burden. In order to supply such parent companies and wholesale consumers, the gas company necessarily had to build larger transmission lines, install more and larger compressor stations, and incur large investment and expense in many other ways which would not be required for the service of the domestic and industrial consumer.

(b) *Adjustment in accordance with former adjudication by the Supreme Court of Appeals of the State of West Virginia.*

The adjustment made by the commission and by the court below on account of the sales to the parent companies has been made in all previous cases before the commission involving the gas company's earnings, and the specific question was the subject of review by the Supreme Court of Appeals of the State of West Virginia in the case of City of Charleston vs. Public Service Commission, supra, and in which the method adopted for such adjustment by the commission herein, and as well by the court below, was specifically approved by the court. The gas company made no application for rehearing in that court, and took no appeal therefrom. Consequently, it is asserted by the commission that such adjustment is a matter which has been formerly adjudicated and is binding upon the gas company in this suit. Former adjudication was alleged and set up in the answer filed by the commission and other defendants to the bill of complaint in this case.

V.

The commission and the court below adjusted the gas company's earnings for the year 1923 by adding thereto the sum of $934,393.41 on account of gasoline earnings.

As heretofore shown, prior to May 1, 1922, in all cases before the commission involving the gas company's earnings and expenses the commission required that the company account for fifty per cent of the net proceeds of the gasoline business, on the theory that that was a reasonable compensation for the privilege of extracting gasoline from the natural gas transported through the company's mains. In May, 1922, the gas company transferred its gasoline business to a subsidiary company, all the capital stock of which is now owned by the two parent companies, and then the gas company entered into a contract with the subsidiary company whereby, among other things, the subsidiary company was to have the right to extract gasoline from all gas transported through the mains of the gas company, in consideration of a royalty of one-eighth of the gross proceeds from the sale of gasoline so produced.

(a) *The adjustment is proper and equitable.*

It appears from the record that 50 per cent of the net proceeds from the gasoline business is very much more than one-eighth of the proceeds of the sale of the

gasoline produced. It is at once obvious that the privilege of extracting gasoline from natural gas transported by the gas company is of great value, and that is conceded by the appellant, but it contends that it has the right to determine what consideration should be demanded and received for this privilege. This is granted if it were dealing with an independent company, and at arm's length, but it will be recalled that the company now exercising such privilege is owned by the same stockholders which own the stock of the gas company. That being true, there can be no separate identities, such as are required for parties to a contract, and the arrangement entered into between the gas company and the company exercising the privilege of extracting the gasoline must be scrutinized closely. The consideration of fifty per cent of the net proceeds for the exercise of such privilege had been prescribed by the commission for many years, and from which action of the commission no appeal has ever been taken by the gas company. Consequently, it must be concluded that the gas company assented to the adjustment as being fair and equitable.

(b) *The adjustment is in accordance with former adjudication by the Supreme Court of Appeals of the State of West Virginia.*

As hereinbefore shown, in the decision of the commission resulting in the order of August 9, 1923, which was the subject of appeal to the State Supreme Court of Appeals, the commission held, in accordance with the gas company's contention, that a royalty of one-eighth of the proceeds of sale of the gasoline pro-

duced was a reasonable consideration for the privilege of extracting gasoline from the gas transported by the gas company. Pursuant to the statute, the City of Charleston, a protestant in such proceeding before the commission, appealed to the Supreme Court of Appeals of the state, and the Supreme Court of Appeals reversed the order of the commission on several grounds, one of which was that the consideration required by the gas company for the privilege of extracting gasoline was inadequate, and that fifty per cent of the net proceeds of the sale of such gasoline was a reasonable consideration, and that the commission should adjust the earnings of the gas company in rate matters accordingly. This decision was in the case of City of Charleston, et al. vs. Public Service Commission, 95 W. Va. 91, 120 S. E. 398. The gas company neither applied for rehearing nor took an appeal from the decision in that case, and it is asserted that such decision constitutes former adjudication on the question. Former adjudication of this question was alleged and plead in the answer filed herein by the commission and other defendants.

VI.

The rates complained of in the bill are sufficient to produce a fair return on the value of the gas company's property, and such rates are, therefore, not confiscatory.

If the earnings of the gas company as a whole are sufficient to afford it a fair return on the present fair

value of its property, after taking care of operating expense and the proper allowances for amortization and depreciation, there can be no confiscation, and the court would be without jurisdiction of the bill in this case.

Assuming that the allowance fixed by the commission for amortization and depreciation, namely, 4.15 per cent of present fair value of the appellant's property for amortization, and 1.12 per cent of book cost of physical property for depreciation, an analysis of the earnings and expenses of the gas company for the year ended December 31, 1923, will conclusively show that the rates allowed by the commission are not confiscatory. On this theory witness Jirgal compiled two statements which were filed before the court below and designated as "Jirgal Exhibit 3, J. C. No. 1" and "Jirgal Exhibit 3 J. C. No. 2." (R. 1161-1162) The difference in the two statements is, that in No. 1 gas sold to parent companies was valued on the basis of the cost of gas at city gate, as explained by Mr. Jirgal at page 379 of the record, and in No. 2 such gas is valued on the basis of the amount paid by comparable companies, as explained by Mr. Jirgal at page 422 of the record. The latter method was adopted by the commission and by the court below. Using the latter method for adjustment of the gas company's earnings for the year 1923, and analyzing the earnings and expenses for such year, it appears that the gas company had net earnings available for depreciation, amortization and return on its whole business of $7,071,414.00. If there be deducted from this sum depreciation and amortization on cost

of reproduction basis, which Mr. Jirgal ascertains at $1,899,537.00, there remains available for return $5,171,877.00. In arriving at this amount it is noted that delay rentals on the entire unoperated acreage have been charged to operating expense and deducted in ascertaining the net earnings as above set forth. Without adding back such rentals, it is found that the sum available for return, namely, $5,171,877.00, will afford a return of eight per cent on $64,649,000.00, which it is submitted is more than the present fair value of the gas company's entire property, including all reserve acreage.

Using the same analysis and allocating the earnings and expenses to West Virginia, it will be seen that net earnings available for depreciation, amortization and return was $1,567,373.00. If amortization and depreciation is deducted from this amount on the basis as allowed by the commission, there is left available for return on the West Virginia property $1,048,800.00, which will afford a return of eight per cent on $13,110,000.00. It is submitted that the present fair value of that portion of the gas company's property used and useful in the service in West Virginia does not exceed the latter sum of $13,110,000.00.

If the amounts paid for delay rentals and charged to operating expenses are added to the net earnings, it will be seen from statement No. 2 aforesaid that the amount available for return on the whole property will be $5,761,063.00, or eight per cent on $72,013,000.00, and that the amount available for return on the West Virginia property will be $1,196,745.00, or eight per cent on $14,959,000.00.

It is submitted that the computations shown on said exhibits (R. 1161-1162) demonstrate conclusively that there can be no confiscation resulting from the rates fixed by the commission.

VII.

The order of the District Court refusing interlocutory injunction should be affirmed.

Respectfully submitted,

F. M. LIVEZEY,

Attorney for Public Service Commission of West Virginia.